FISCAL NOTE

Bill #: HB0714 **Title:** Optional simplified income tax filing

Primary Sponsor: Balyeat, J **Status:** As Amended in House Committee

Sponsor signature Date Chuck Swysgood, Budget Director Date

Fiscal Summary	**FY 2004 Difference**	**FY 2005 Difference**
Expenditures:		
General Fund	$0	$0
Revenue:		
General Fund	$0	0
Net Impact on General Fund Balance:	$0	$0

- [ ] Significant Local Gov. Impact
- [ ] Included in the Executive Budget
- [ ] Dedicated Revenue Form Attached
- [ ] Technical Concerns
- [x] Significant Long-Term Impacts
- [ ] Needs to be included in HB 2

Fiscal Analysis

ASSUMPTIONS:

1. Under this bill, taxpayers could elect to be taxed under an alternative system for individual income tax purposes. Once made, the election to be taxed under the alternative system is irrevocable and the taxpayer is subject to tax under the alternative system in all subsequent tax years. Married taxpayers must make the election jointly.
2. Under the alternative system, the taxpayer's state liability is tied to federal taxable income. Taxpayers electing to use this method are not allowed to take any of the state-level adjustments, deductions, exclusions or credits (other than the credit for taxes paid to other states) otherwise available to taxpayers using the current system. Prior to calculating tax liability, taxpayers must adjust federal taxable income by subtracting any interest income from US obligations, railroad retirement income, and income earned while a tribal member on an Indian reservation. In addition, taxpayers must add to federal taxable income and interest income from non-Montana state and local government bonds. In the first year of the election, taxpayers must also add to income and refunds of federal income taxes received to the extent that those refunds provided the taxpayer with a tax benefit from being deducted for state income tax purposes in a previous year (tax benefit rule applies in the first year).
3. Once adjusted federal taxable income has been determined, taxpayers pay tax based on separate tax rate tables for single filers and married couples filing separately; heads of households; and married couples filing jointly. It is assumed that under this method all married couples will file jointly, as there is little or no incentive to file separately due to the separate rate tables provided for married couples who file separately. Under the proposed tax rate tables, marginal tax rates range from 7% to 9.6% for all

taxpayers. The 9.6% tax rate would apply to taxable income over $20,000 for married couples filing jointly; to taxable income over $16,000 for heads of households; and to taxable income over $10,000 for single filers.

4. Under the alternative system, all taxpayers must pay a tax of $90 in addition to any tax determined by applying the proposed tax rate tables to adjusted federal taxable income. Under this provision, all taxpayers will pay a minimum tax of $90, regardless of whether they have any net positive taxable income or not.
5. Under the amended version, the bill is effective January 1, 2006 and applies to tax years beginning after December 31, 2005 (tax year 2006). Because of the delayed effective date, there is no revenue impact or and administrative cost impact from this proposal in the 2005 biennium (see long-range impacts section of this fiscal note for impacts of this proposal in future years).

<u>LONG-RANGE IMPACTS:</u>

1. Beginning in tax year 2006, taxpayers would have the option to elect to file using the alternative individual income tax system provided for in this bill. Because of the initial relatively high proposed marginal tax rates provided in the bill, only a few select types of taxpayers would find it beneficial to switch to the alternative method immediately. These include primarily those taxpayers for whom the greatly increased standard deduction and personal exemption values at the federal level result in a lower tax liability than under current law, notwithstanding the $90 minimum tax liability under the proposal. While this would include thousands of lower income taxpayers and households, the resulting revenue reduction would likely be well under $1 million at first.
2. There are other types of taxpayers for whom it also would be beneficial to use the alternative approach in any single, given year. For example, some taxpayers would find it beneficial to switch simply because their taxable incomes in a particular year (say, a year in which the taxpayer sells a business, farm, or ranch for a one-time large income) are high enough such that the lower top rate of 9.6% under the proposal provides them with a reduction in liability relative to the top rate of 11% in current law, regardless of the changes in standard or itemized deductions and personal exemption amounts. It would also be beneficial for those taxpayers who, for whatever reason, have very large incomes in a given year, but have not paid the requisite federal income tax on that income in the same year. In this case the taxpayer would pay an inordinately high state income tax due to the fact that the taxpayer did not receive the benefit of the full federal income tax deduction for state income tax purposes.
3. In these latter cases, it is impossible to determine whether or not these types of taxpayers would switch to the new system. Because the bill provides that the switch is irrevocable these taxpayers are likely to wait for several years to see if the new system would be of benefit in the long run.
4. Over time, if growth in individual income tax collections exceeds growth in inflation, the tax rate adjustment mechanism provided for in Section 2, subsection (6) of the bill will act to gradually reduce the tax rates provided for initially in the bill. As these rates come down, more and more taxpayers will find it beneficial to switch to the new system. There is no way of determining how many taxpayers will switch, or when they will switch in future years.
5. Because of the delayed implementation date provided for in the bill, there are no administrative cost impacts in the 2005 biennium. However, the Department of Revenue would incur administrative costs of approximately $750,000 in the 2007 biennium to implement the provisions of this bill.